

Bond Insurers: Issues for the 110th Congress

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Summary

Beginning in 2007, higher than expected defaults and delinquencies in “subprime” mortgages led to a significant slowdown of the housing market. Most of these mortgages were financed by capital markets through asset- or mortgage-backed securities, rather than by traditional banks. Thus, rather than being confined to the institutions that made the now-questionable loans, losses caused by unexpected mortgage defaults have been felt throughout the financial system by any entity who bought mortgage-backed securities. In addition, financial guaranty insurance companies, often known as “monoline” insurers, have also been affected because they insured the prompt payment of interest and return of principal for various securities that may now not be able to pay the promised amounts. With most possible insurance payouts still in the future, these insurers have yet to experience large real losses. Possible massive future losses, however, have caused financial turmoil for insurers, downgrades from rating agencies, and fears about further harm to other institutions, individuals, and municipalities. While the federal government does not currently oversee any insurers, various proposals for broad federal oversight have been introduced, including S. 40/H.R. 3200 in the 110th Congress. The House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises held a hearing entitled “The State of the Bond Insurance Industry” on February 14, 2008, and the full Financial Services Committee is scheduled to examine “Municipal Bond Turmoil: Impact on Cities, Towns, and States,” on March 12, 2008.

The financial guaranty insurance industry began less than four decades ago with insurance policies being offered on municipal bonds. Bond insurers became known as monoline insurers because they were limited by the regulators to offering financial guaranty insurance, and relatively few companies entered the business. While insuring municipal bonds has remained the majority of their business, bond insurers also expanded into offering insurance for international bonds and the aforementioned asset-backed securities. The insurance provided on the asset-backed securities has been offered through relatively new financial derivatives known as credit default swaps, rather than through traditional insurance policies. The coverage provided through such swaps has in most cases been essentially identical to that provided through traditional insurance policies, but the accounting treatment is different for these tradeable contracts. As the risk of default for the underlying securities has risen, the value of the credit default swaps to insurers has fallen, resulting in multi-billion dollar paper losses for bond insurers.

With the possibility of wider financial damage spilling over from bond insurer difficulties, various market participants and government regulators have broached the idea of some sort of rescue for the troubled insurers. Uncertainty about the need for, and size of, such a rescue, as well as complexities in the bond insurer situation have stymied any such rescue to this point. In addition to the immediate demands of crisis management, the turmoil surrounding the bond insurers may also bring longer term regulatory issues to the fore, including questions about future federal oversight regulation of insurers and future federal oversight of derivatives, many of which are essentially unregulated. This report will be updated as events warrant.

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Introduction

In 2007, much higher than expected defaults and delinquencies in the “subprime” segment of the mortgage market, led to a significant slowdown of the housing market. Most of these mortgages were financed not by traditional banks, but by global capital markets through asset or mortgage-backed securities. Thus, rather than being confined to the institutions who made the loans initially, the losses caused by the unexpected volume of mortgage defaults have been felt throughout the financial system by any person or institution who bought such securities.¹ In addition, financial guaranty insurance companies, often known as “monoline” insurers, have also been impacted because they provided insurance for various asset-backed bond issues. These insurers also insure a variety of other bonds. Consequently, if the ratings of a bond insurer should fall (due to widespread default problems associated with a particular category of bonds), then the ratings of other bonds insured by the same firm will also decline. Such spillover and contagion effects are raising questions regarding the possibility of a government-sponsored rescue of bond insurers in difficulty.

Although the federal government does not currently oversee insurers, various proposals for broad federal oversight of all insurers have been introduced, including S. 40/H.R. 3200 in the 110th Congress.² The House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises held a hearing on “The State of the Bond Insurance Industry” on February 14, 2008, and the full Financial Services Committee is scheduled to examine “Municipal Bond Turmoil: Impact on Cities, Towns, and States” on March 12, 2008. At the time of writing, there have been no bills focused on the current bond insurance market introduced.

This report begins with a description of the bond insurance industry and its business model, including the relatively recent move into providing insurance for asset-backed securities. An analysis of the current market difficulties follows along with the various possibilities of spillover effects. Finally, a number of broader policy questions are briefly discussed. This report will be updated as events warrant, particularly if and when Congress takes action on the issue.

The Bond Insurance Industry

The bond insurance industry is small relative to the entire industry as a whole. According to the Association of Financial Guaranty Insurers (AFGI), total premiums collected in 2006 by the 12 insurers and reinsurers³ that represented nearly all the industry were \$3.2 billion.⁴ In comparison, the total direct premium collected by U.S. property/casualty insurers in 2006 was \$447.8 billion,⁵ and that collected by life and health insurers was \$619.7 billion.⁶ While the total premium volume is fairly low, the total net par value of the bonds insured by its members is much higher, namely

¹ See CRS Report RL34182, *Financial Crisis? The Liquidity Crunch of August 2007*, by Darryl E. Getter et al.

² See CRS Report RL34286, *Insurance Regulation: Federal Charter Legislation*, by Baird Webel.

³ The 12 AFGI insurers and reinsurers were ACA Financial Guaranty Corp, Ambac Assurance Corp., Assured Guaranty Corp. (AGO), BluePoint Re, Ltd., CIFG Holding Corp., Financial Guaranty Insurance Company (FGIC), Financial Security Assurance (FSA), MBIA Insurance Corp., PMI Guaranty Co., Radian Asset Assurance, RAM Reinsurance Co., and XL Capital Assurance. In February 2008, however, MBIA left AFGI. Another smaller bond insurer that is not a member is Security Capital Assurance (SCA). In response to the crisis, Berkshire Hathaway recently created a new bond insurer domiciled in New York. Given Berkshire’s financial strength, it could become a major player in this market, but has yet to do so.

⁴ See <http://www.afgi.org/fin-annualrept06.html>.

⁵ From the Insurance Information Institute’s website at <http://www.iii.org/financial2/insurance/pcpbl>.

⁶ From the Insurance Information Institute’s website at <http://www.iii.org/financial2/insurance/lhpbl>.

\$2.3 trillion with four companies, Ambac, FGIC, FSA, and MBIA, insuring approximately \$2.0 trillion of that \$2.3 trillion. The oldest of the insurers, Ambac Assurance Corporation, was established less than 40 years ago. The bond insurance sector is relatively small because the companies are restricted, under the state chartering laws, to providing only one kind of insurance, financial guaranty insurance, which is why they are often referred to as monolines. While this restriction applies to the business activity of providing financial guarantees to securities, it does not limit the types of securities that can be insured.

Bond insurance basically guarantees bond purchasers that interest payments will be made on time, and if the issuers default, that principal will eventually be returned. This insurance is typically purchased by the issuer of the bond for a one-time payment. The purpose of this insurance, therefore, is to “credit enhance” or raise the credit rating that would have been assigned based upon the financial strength of the original issuer to that of the insurance company guaranteeing the bond. A higher credit rating may be useful for issuers wanting to attract more investors, in particular smaller bond issuers or those unfamiliar to most investors. Many institutions also prefer highly rated “AAA”⁷ securities either because risk-based capital requirements are less for institutions holding such securities or, in the case of mutual funds, because of specific investment requirements. Issuers without the necessary capital reserves can still obtain higher ratings for their securities by purchasing bond insurance.

Municipal Bonds and Asset-Backed Securities

Monoline insurers began writing insurance for municipal bonds, and this insurance remains their primary business (60% of their total according to AFGI). Over the past 10 years, the annual share of municipal bonds that are issued with bond insurance has varied from approximately 40% to more than 55%⁸ with the current total being approximately 50% of the outstanding municipal bonds. Municipal bonds are typically purchased for their tax advantages, often by individual investors who are not seeking risky securities. Individual households held \$911 billion in municipal debt at the end of the third quarter of 2007, 35.4% of the total. Other large holders of municipal debt include various types of mutual funds (\$895.6 billion or 34.8%) and property/casualty insurance companies (\$346.8 billion or 13.5%).⁹

Insuring municipal bonds historically been a low-risk line of business. Municipalities rarely default on their bond offerings, so the losses required to be paid by insurers have been very low. While they rarely default, municipalities often do not maintain the capital reserves or other requirements rating agencies look for in awarding AAA ratings. Bond insurers sought a AAA rating so the bonds they insure would also share this status, making the insurance attractive to many municipalities. If a bond insurer were to lose its AAA rating, it would become very difficult, if not impossible, for the firm to write new business. If a monoline is unable to attract new business, they would be forced to pay any existing claims with existing resources, rather than being able to rely upon the cash flow from new business. The bond insurer would essentially be in what is known as “run off” in the insurance industry unless the AAA rating could be re-established. Hence, protection of a AAA rating is essential for such insurers to remain ongoing concerns.

⁷ Different rating agencies have different precise ranking systems. This report generally follows the rankings put out by Fitch and S&P, which has AAA as the highest, followed by AA, A, BBB, BB, B, and CCC.

⁸ “Bond Insurance Totals and Market Share 1997-2006,” *The Bond Buyer/Thompson Financial 2007 Yearbook*, p. 94.

⁹ Dollar amounts from Federal Reserve Board, *Flow of Funds Accounts of the United States*, “L.211 Municipal Securities and Loans,” December 6, 2007, p 89. Available at <http://www.federalreserve.gov/releases/z1/Current/z1r-4.pdf>. Percentages calculated by CRS.

Over time, bond insurers expanded the types of products that they insured, branching out into public and infrastructure bonds originated by issuers from other countries (14% of their business according to AFGI), and into other classes of asset-backed securities also known as structured finance or securitization (26% of the business). Structured finance is the process of pooling similar types of financial assets (typically loans) and transforming them into bonds or debt securities. Investors typically purchase these asset-backed securities by paying an initial lump sum, and they are repaid the principal and interest over time with the cash flows generated from the underlying assets. Monolines began to guarantee asset-backed securities in the 1990s. Ambac, for example, created a specific division to focus on these securities in 1993.¹⁰

Movement into Credit Default Swaps

A traditional insurance policy is a long-standing method of protecting oneself from financial loss. As financial markets have become more sophisticated, however, other financial instruments have been developed that may offer similar protection in a different form. Derivatives known as credit default swaps (CDS) are one of these newer instruments. A CDS is an agreement between two parties where the seller agrees to provide payment to the buyer in the event of a third party credit event, such as default on a security. In return, the buyer typically makes periodic payment to the seller. From an economic point of view, a CDS can be identical to an insurance policy. Unlike a traditional insurance policy, however, CDS are not regulated by state insurance departments and are tradeable assets that can be easily bought and sold on the open market. The CDS contract terms can be whatever the two parties agree to, and there is no general requirement that any capital be held by the seller to back the promise made in the contract.

When monoline insurers expanded into offering guarantees for asset-backed securities, they apparently did so as protection sellers on CDSs rather than through selling more traditional insurance products. The move to CDS, however, did require the creation of separate subsidiaries to offer the CDS, because state insurance regulators generally would not allow insurance companies to offer them. The insurers, however, were allowed to write insurance policies to their subsidiaries guaranteeing the CDS entered into by the subsidiaries.

According to AFGI, the movement toward CDS contracting was initiated by its customers due to more favorable accounting treatment and regulatory reasons. As long as the CDS contract is on the same terms as the traditional insurance policies, the switch to CDS contracting would not alter capital requirements for the financial guarantor wanting to maintain a very high credit rating. Both AFGI¹¹ and the individual bond insurer MBIA¹² indicate that the vast majority of the CDS offered by bond insurers mirrored the guaranty of the traditional products—namely, prompt interest payments and ultimate return of principle under the original terms of the security. (In response to CRS questions, AFGI also indicated that one insurer, ACA, which already has been severely downgraded, had entered into some swaps that required payment if the insurer were downgraded, which likely contributed to its difficulties.)

One important difference between CDS and traditional insurance is the accounting treatment. As a tradeable instrument, a CDS must be assigned a current value, or “marked to market,” on a

¹⁰ See “About Us” on Ambac’s website at <http://ambac.com/aboutus.html>.

¹¹ Email exchange between the author and representatives of the Association of Financial Guaranty Insurers, January 26, 2008.

¹² “MBIA’s Selective Approach to Subprime RMBS and Multi-Sector CDOs,” Presentation dated August 2, 2007, p. 21, available on MBIA’s website at <http://library.corporate-ir.net/library/88/880/88095/items/256631/MBI080207pres1.pdf>.

company's financial statements under standards put forth by the Financial Accounting Standards Board (FASB).¹³ Changes in the value of the contract must generally be reported as current income during each reporting period. An insurance policy, however, is not marked to market in a similar manner. Thus, if there is significant increase in a default risk that is being covered by a CDS, the market value of the CDS to the buyer would rise significantly, (the value to the seller would, of course, drop significantly) and this rise (or drop) would have to be reflected on the income statement. This would not be the case if the identical risk were covered by an insurance policy. This accounting difference between traditional insurance policies and CDS holds even if the economic substance and legal commitment of the insurance policy and the CDS are identical.

Current Bond Insurer Situation

As noted above, the current difficulty in the bond insurance market is rooted in the unexpected rise in mortgage defaults and foreclosures, which caused an increase in defaults on a number of mortgage-backed securities, including many that had previously been thought to be essentially risk-free. This crisis affects bond insurers in a number of ways. The most straightforward is that, if they insure any securities that default due to the non-performance of the underlying mortgages, the bond insurer would be responsible for paying off these securities, which would mean an increase in future payments to be made by the insurer. A second, more immediate impact would be on the insurer's balance sheet, particularly if the insurance protection is provided in the form of CDS, rather than a traditional policy. Even if default has not occurred, as the probability of default on a security covered by a CDS increases, the insurers offering the protection must show a loss on their books, even if the immediate cash flow has not changed. Finally, the bond insurers may be affected by generally increased skepticism on the part of investors and the ratings agencies.

Over the past months, market sentiment on bond insurers has turned substantially negative. Stock prices for bond insurers are down substantially, nearly 90% in the last year for Ambac, which has been downgraded to Aa by one rating agency (Fitch), but has to this point kept AAA ratings from Moodys and Standard & Poor's. Other downgrades have included FGIC to AA by Fitch and Standard & Poor's, and SCA to A by Fitch. One insurer, ACA, has been downgraded all the way to junk levels by Standard and Poor's. Several insurers have scrambled to raise capital to avoid being downgraded. Two large insurers, MBIA and Ambac, have been successful in raising sufficient capital to maintain AAA ratings from at least two of the rating agencies. Multi-billion dollar paper losses have been reported, primarily from the value of the insurers' CDS contracts. New York State Insurance Superintendent Eric Dinallo has held meetings with various banks and other financial institutions attempting to arrange some kind of rescue package to prevent further downgrades. No rescue package has been forthcoming from Superintendent Dinallo's efforts, although they may have contributed to the ability of some of the insurers to raise new capital. Losses in the hundreds of billions of dollars throughout the financial system have been foreseen by some analysts.

Different market participants have come up with dramatically different views on the future of the bond industry. Two competing views are summarized below, the first promoted, unsurprisingly, by many in the bond industry, while the second is voiced more by outside skeptics.

¹³ FASB Statement FAS 133 covers accounting for swaps and other derivative financial instruments. It can be found at <http://www.fasb.org/st/summary/stsum133.shtml>.

An Optimistic View

According to this view, the bond insurers are not in trouble for the following reasons: First, when bonds go into default, the insurer pays only the interest and principal at the time the payments are scheduled. The firms generally do not have to accelerate the payment schedule if the insured bond defaults, if the insured bond's credit rating falls, or if the guarantor's rating falls. As a result, the concern over monolines being unable to meet their payment obligations has been somewhat exaggerated. Second, it is argued that, because a credible reputation is extremely valuable to attracting future business, financial monolines only insure highly-rated bonds. Based on this assumption, it is unlikely that they would have insured the riskier bonds backed by subprime mortgages. Third, turmoil in the mortgage-backed security market associated with the subprime crisis may effect the liquidity and value of all such securities, even those that do not contain subprime loans. While investors trying to sell these securities are likely to absorb losses associated with falling mark-to-market values, it is maintained that insurers would only be affected if the underlying mortgage holders failed to make payments. As long as cash payments are still being made, the declining market value of the securities would not trigger any losses from the guarantor, since the market value of the security is not being insured. Hence, optimists maintain that insurers, while buffeted by a skeptical market, are not headed for long-term financial trouble.

A Pessimistic View

The pessimistic view holds that monoline insurers are in serious trouble. Pessimists observe that past ratings of monolines not only fail to reflect the increase in default associated with the increase of the share of asset-backed bonds they guarantee, but that these bonds are backed by assets highly susceptible to default, such as subprime mortgages. From this perspective, the guaranty industry did, in fact, agree to provide insurance to the riskier securities backed by subprime mortgages, and their ratings should be revised to reflect a high level of financial risk. Those making this argument assert that the industry is currently not fully disclosing all information that will eventually emerge as the financial market turmoil continues.

It is possible as well that the situation falls somewhat between the two. As was noted above, monoline insurers expanded their business from providing insurance to municipal bonds to providing insurance to asset-backed securities/bonds, some of which were backed by mortgage loans. Even in the absence of a mortgage default crisis, mortgage loans generally have a greater probability of default than municipal bonds. Previous ratings of financial monolines, therefore, may not have reflected the increase in default risk solely resulting from a shift in the ratio of bonds backed by municipals relative to bonds backed by other types of financial assets. Hence, the current ratings pressures may be the market accurately reassessing the prospects of the insurers in their expanded line of business. If this is correct, the monoline industry may need increased capital to back the riskier bonds and retain a AAA rating, but it may not be in risk of default or bankruptcy. At the February 14 hearing, Secretary Dinallo indicated that he did not see the bond insurers at risk for insolvency, but that they were definitely facing difficulties in maintaining their ratings.

Important considerations going forward include the following:

- Will a large portion of the bond insurance market be downgraded?
- Would downgrades lead to fewer customers and put the insurers in serious jeopardy?

- What percentage of securities backed by monolines eventually go to claim, thus requiring the insurers to make substantial real payments?
- Are there other surprises in the insurers' books? Did the insurers in fact insure more risky securities than is currently indicated?
- Are any of the insurers, like ACA, counterparty to derivatives that might require immediate payment upon a downgrade?

Spillover Effects from Monoline Difficulties

The direct impact of a monoline insurer being downgraded from AAA is critical for that company. What may not be obvious, however, are the effects on other actors in the financial system, some of whom may never have even heard of the asset-backed securities and credit default swaps that are the catalyst for the current problems. These participants and possible impacts are discussed below.

Individual Investors

The crucial question for individuals holding municipal bonds is whether they are “buy and hold” investors who are using the bond for ongoing income and then the return of principle at maturity, or whether they are intending to sell the bonds before maturity. For the buy-and-hold investor, the downgrade makes no difference, unless the bond issuer defaults in the future. Since municipal bond defaults are exceedingly rare, the downgrade will likely have no impact on this investor. For someone intending to sell the municipal bonds before maturity, the downgrade cuts the value of the bond. How much of a loss in value would depend on how low the insurer was downgraded and the rating on the underlying bond. In addition to holding individual municipal bonds, many individuals hold the bonds indirectly through mutual funds. These individuals are facing losses in the value of the funds just as the individual who was planning on trading the bonds that he or she owned.

Municipalities

For the large majority of insured bonds that have already been sold, it makes essentially no difference to the issuing municipality whether or not the insurer is downgraded as the municipalities commitment to pay off the terms of the bond is unchanged. The exception to this is a small class of securities known as auction-rate securities. Although these are long-term securities, the interest rate paid by municipalities is set at periodic auctions. The turmoil in the market, including doubts about bond insurers, has caused many of these auctions to fail, resulting in higher immediate interest costs for municipalities issuing these bonds. In 2006, approximately 8.5% of the municipal bond volume were auction-rate bonds. The dollar value was \$32.99 billion, of which \$21.39 billion was insured.¹⁴

In the future, however, municipalities will likely face a choice between paying a higher premium on insurance from one of the remaining AAA-rated bond insurers, assuming that AAA-rated bond insurers remain, or paying a higher interest rate for their bonds if they offer them either without insurance or with lower rated insurance. In 2007, a AAA-rated bond's average yield was 4.07%, compared with 4.17% for AA, 4.43% for A, and 4.78% for BAA.¹⁵ Depending on the comparison

¹⁴ “Auction-Rate Bonds,” *The Bond Buyer/Thompson Financial 2007 Yearbook*, p. 227.

¹⁵ Yields are 2007 averages from Moody's 20-Year Municipal Bond Yields of the various ratings levels. Data from

between future insurance premiums and interest rates on differently rated bonds, significant numbers of municipalities might choose to forgo bond insurance altogether. The possible damage to future municipal bond offerings was reportedly a significant factor in Superintendent Dinallo's encouragement of the newly created Berkshire-Hathaway bond insurer.¹⁶

Other Financial Institutions

Financial and institutional investors holding insured securities that lose AAA ratings may find they are no longer in regulatory compliance after these downgrades. Banks and insurers face regulatory requirements concerning the amount of capital they must hold against their outstanding loans and written insurance policies. Some pension funds are required to hold AAA investment grade securities. Downgrades will subsequently reduce the value of holdings, and these investors must hold more capital or rebalance their portfolios with higher quality assets. Estimates of the magnitude of this effect are obviously highly speculative at this point in time, and the range of estimates is very wide. One Barclays Capital analysis puts the additional capital needed by global banks to be as high as \$143 billion.¹⁷ This \$143 billion figure includes both U.S. and European banks, and takes into account the market value losses as well as the increased capital required by regulators since the banks would be holding lower-rated securities. A Morgan Stanley analyst, however, reportedly indicated on a conference call that they found total bank exposures in the United States to be in the \$20 billion to \$25 billion range with likely losses being \$5 billion to \$7 billion.¹⁸

Future Policy Issues

The future of the individual bond insurers revolve around the actual extent of their losses on asset-backed securities and whether or not they are able to retain their AAA ratings. While the answer to these questions are largely unknowable at the moment, the situation does seem to raise three significant policy questions:

- Is an immediate federal government response necessary to address the situation and avert possible widespread losses and systemic risk?
- Was a regulatory failure at least partially responsible for allowing conditions for a potential crisis situation to exist?
- What regulatory changes, in particular those addressing the use of derivatives, may prevent future financial instability?

If the potential losses are truly so high, it would seem to be in the self-interest of a wide number of financial institutions to help the insurers retain their AAA rating with or without direct government intervention. Unless a single, very well capitalized individual or firm becomes convinced that buying out a large bond insurer made business sense, the odds of a purely private rescue seem small. This is primarily due to the collective action problems due to the large number of actors involved. Even if the overall losses would be huge, for each individual bank or insurer affected, the most logical course of action may be to sit back and let somebody else put their

<http://www.globalfinancialdata.com>.

¹⁶ "A Regulator Not Stymied by Red Tape," *New York Times*, January 9, 2008, p. C1.

¹⁷ *Monoline Downgrades: Implications for the Financial Sector*, Barclays Capital, January 25, 2008, p. 4.

¹⁸ "Bank losses from monolines seen up to \$7 billion: analyst," Reuters, February 4, 2008, available at <http://www.reuters.com/article/ousiv/idUSN0427726020080205>.

money up to solve the problem. In such a case, government coordination, even if no government money is directly involved, might avert the larger loss. This was essentially the solution to the 1998 Long Term Capital Management (LTCM) failure that was brokered by the Federal Reserve.¹⁹ The bond insurer situation, however, is much more complicated than LTCM was. There are several bond insurers in difficulty and hundreds or thousands of institutions that could be affected if the insurers fail. To this point, the direct government intervention has been much less, than in the LTCM rescue. The primary government official pushing for some sort of solution right now is Superintendent Dinallo, who is the insurance regulator of the state where most bond insurers are based, but who does not have the same overall status that the leadership of the Federal Reserve did in the LTCM crisis.

The current absence of federal involvement at the micro level points to the more macro questions about regulatory failure. The bond insurers, like all insurers, are state regulated entities. While most are domiciled in New York, the largest, Ambac is domiciled in Wisconsin, and the insurer most negatively affected by the current crisis, ACA, is domiciled in Maryland. Questions by Members of Congress about whether state insurance regulators have the ability to ensure the solvency of insurers were raised in earnest in the late 1980s after several large insolvencies and have continued as the financial services marketplace has become increasingly complex since then. The current bond insurer difficulties will likely cause such questions to be raised again due to the central role played by the relatively new and sophisticated financial instruments, such as credit derivatives and collateralized debt obligations.

In addition to the question of how insurers should be regulated, the crisis also may raise questions about whether and how financial derivatives, such as the credit default swaps offered by the bond insurers, should be regulated. Currently, some derivatives trading is regulated by the Commodity Futures Trading Commission under the Commodity Exchange Act.²⁰ Other derivative instruments, including CDS, are traded in over-the-counter (off-exchange) markets that are essentially unregulated. Congress has repeatedly considered the question of whether unregulated derivatives markets have the potential to facilitate fraud, price manipulation, or financial instability; for example, in December 2007, the Senate passed legislation (H.R. 2419, Title XIII) that would expand the CFTC's authority over currently unregulated energy derivatives. Unregulated financial derivatives markets have increased in size such that a widespread crisis in derivatives could cause substantial damage to the rest of the financial system and lead to a downturn in the real economy. This sort of systemic risk is seen as a major rationale for regulating other financial services, such as banks. If derivatives are posing a similar systemic risk, some may point to this in arguing for their regulation as well.

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¹⁹ See CRS Report 94-511, *Hedge Funds: Should They Be Regulated?*, by Mark Jickling.

²⁰ 7 U.S.C. §§ 1-25.

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